

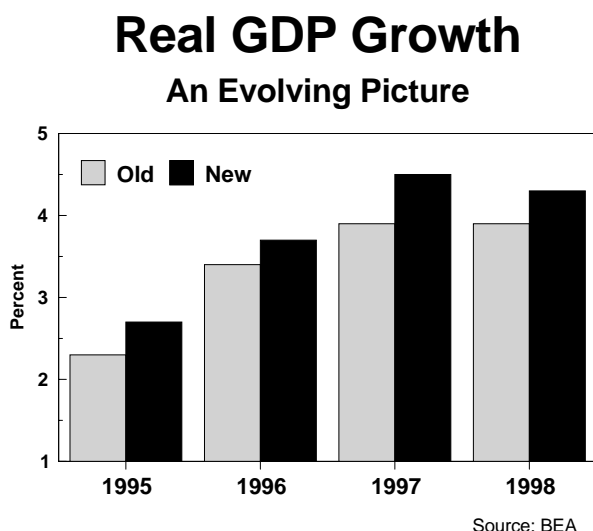
October / November 1999

US Overview: Shifting Views on Inflation

For most of October, financial markets were pounded by fears that inflation risks were on the rise. This caused the Dow to fall briefly below 10,000 while long-term bond yields hit a two year high. Yet, at month's end, sentiment reversed sharply. Last week, markets ignored a near 5 percent surge in third quarter GDP and focused instead on restrained growth in the GDP price index and the Employment Cost Index. In combination with market elation over the upcoming passage of Financial Services Modernization legislation, financial markets surged into month-end. Have concerns about economic overheating gone for good? Unfortunately, the answer is likely "no." Concerns may resurface as October employment and output measures rebound from their Hurricane Floyd-depressed September readings.

Impressive GDP Report and Benchmark Revisions

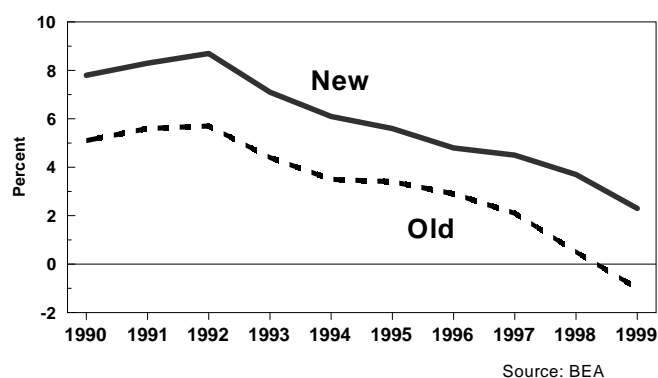
Real GDP grew an impressive 4.8 percent in the third quarter. Strength was broad-based: although slowing a bit from its earlier pace, consumption still grew in excess of four percent, while business investment and exports surged at a double digit pace. The only main sources of weakness were residential housing and rising imports.



Benchmark revisions to the GDP series made the past look a lot better as well. Real GDP growth was revised up by an average 0.4 percentage points per year from 1991 to 1999. This was driven by Commerce's decision to include non-bundled software in business investment. (Previously, it had assumed that these purchases were inputs to production.) In addition, technical revisions to the GDP price index pulled down measured inflation and therefore boosted real growth for this period.

These GDP revisions will bump up estimates of the economy's long-run rate of sustainable growth. However, these changes do not fundamentally affect the question of whether the economy is overheating presently or not – while the so-called "economic speed limit" has risen, so too has measured speed!

Personal Savings Rate An Evolving Picture



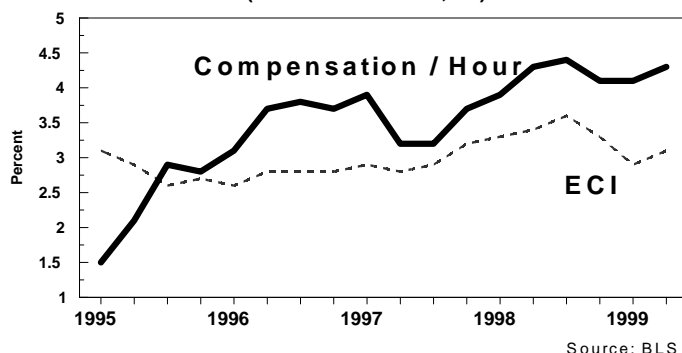
BEA also changed its calculation of personal savings. It now classifies government pensions as private savings instead of government savings. This inflates the former savings measure and reduces the latter by equal amounts, while leaving national savings unchanged. However, this change does push the US personal savings rate up from negative territory to roughly positive two percent. Given the notable effects that definitional changes can have, one should focus more on the trend in the savings rate rather than on its level. What has (and continues to concern) economists is the marked decline in the personal savings rate in recent years as household net wealth has surged in line with the stock market.

Is Overheating Still A Concern?

After last week's mild Employment Cost Index release, markets seemed to have shaken off their fears of inflation. Unfortunately, the factors behind the original fears remain -- although this year's back-up in long-term interest rates may be starting to have a dampening impact on the housing market, the economy remains red hot, the pool of available workers is shrinking and signs of price pressures in the pipeline continue to surface. That said, it is unusual that tight labor conditions have not translated into greater wage gains thus far. However, the picture can vary depending on what statistic is cited. The Employment Cost Index -- which ignited last week's financial market rally -- is actually one of the poorer measures of wage pressure in today's tight job markets.

In a recent working paper, Federal Reserve researchers suggested that the ECI likely understates true compensation gains by 0.3 percentage points since it does not pick up many new, non-standard methods of compensation including hiring/retention bonuses and stock options. Private economists have highlighted other downside biases -- since the ECI tracks compensation gains for a given occupation, it would not reflect a pay rise if it occurred in conjunction with a promotion. This latter phenomenon occurs much more frequently in tight labor markets and suggests ECI's overall downward bias has likely grown in recent months.

Compensation Growth (Year over Year, %)



Other measures are less biased. For instance, the "compensation per hour" statistics do include realized stock options (although they also omit unrealized stock option gains) and are not affected by the downward bias due to promotions. For these reasons, this latter measure is running about one percentage point faster than ECI and has been rising more steadily in recent years as one would expect, given increasing labor market tightness.

If there are still risks of overheating and future price pressures, will the Fed move to raise interest rates at its November 16th meeting? In a recent survey of 30 economists by CNN, 60 percent looked for a 25 basis point rate hike. However, with the Fed balancing inflation risks with Y2K considerations, this meeting could be quite a cliffhanger.

Selected Issue: Global Recovery

The US is not the only nation experiencing impressive growth. The economic outlook in the rest of the world continues to improve – this is all the more notable considering that it was just one year ago this month that markets were gripped with fears of a sustained global depression/deflation.

Emerging Nations **Real GDP Growth (%)**

	1998	1999	2000 (P)
KOREA	-5.8	6.5	5.5
SINGAPORE	0.4	4.5	5.0
THAILAND	-9.4	4.0	4.0
HONG KONG	-5.1	1.2	3.6
MEXICO	4.6	3.0	5.0
ARGENTINA	3.9	-3.0	1.5
BRAZIL	0.1	-1.0	4.0

Source: World Economic Outlook September 1999, IMF

Some of the most impressive growth is occurring in South East Asia. After seeing their economies shrink in excess of 5 percent in 1998, many are posting growth of similar magnitude this year in a so-called “V” shaped recovery. Growth has been helped by a recovery in exports (reflecting depreciated currencies and better growth prospects in major trading partners) and the relaxation of financial market pressures which have allowed respective central banks to lower interest rates. Recovery has been particularly strong in Korea and Thailand, two nations which adhered the most closely to prescribed IMF stabilization plans. Latin America’s recovery has not been as impressive, although this is partially due to the fact that they went into crisis after Asia.

Industrial Nations **Real GDP Growth (%)**

	1998	1999	2000 (P)
UNITED STATES	3.9	3.7	2.6
JAPAN	-2.8	1.0	1.5
GERMANY	2.3	1.4	2.5

Source: World Economic Outlook September 1999, IMF

The improvement in the global economy has helped the growth outlook of Europe and Japan as well. After a lackluster late 1998/early 1999, Europe’s growth has quickened recently, leading many to forecast a notable pick-up in 2000. While first led by robust export growth (due to the weaker euro and better global conditions), there have been encouraging signs of a pick-up in EU consumer demand recently. In deference to this improvement and a pick-up in money growth, there is widespread speculation that the European Central Bank will conclude that its overly accommodative monetary policy is no longer needed and will soon boost its main interest rate from 2.5 percent to 3.0 percent.

Even Japan's economic outlook has improved. After contracting nearly 3 percent in 1998, Japan's economy grew sharply in the first half of 1999. While the lagged effects of prior government stimulus packages drove roughly half of this pick-up, private demand still showed strength. While economists expect that growth will be slightly negative in the second half of 1999, most believe that Japan's economy has turned the corner. Interest rates are expected to remain near zero for the foreseeable future, which should help the economy expand further in 2000.

U.S. Economic Indicators

	Q 4-98	Q 1-99	Q 2-99	Q 3-99	Most Recent
Real GDP Growth	6.0	3.7	1.9	4.8	
Trade Deficit (\$bn)	-43.0	-54.0	-65.0	N/A	-24 (Aug.)
Unemployment Rate	4.4	4.3	4.3	4.2	4.2 (Sep.)
Productivity Growth	4.2	3.7	0.7	N/A	
CPI Inflation	1.6	1.7	2.1	2.3	2.6 (Sep.)
30 Year Treasury Yield	5.2	5.6	6.1	6.1	6.2 (Oct.)
Dow Level	9,200	9,800	11,000	10,400	10,700 (Oct.)